

# DOCKET SECTION

BEFORE THE  
POSTAL RATE COMMISSION-  
WASHINGTON D.C. 20268-0001

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POSTAL RATES AND FEE CHANGES, 1997

Docket No. R97-1

TRIAL BRIEF

OF

NASHUA PHOTO INC., DISTRICT PHOTO INC.,  
MYSTIC COLOR LAB, SEATTLE FILMWORKS, INC., AND  
MERCK-MEDCO MANAGED CARE, L.L.C.

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## **I. INTRODUCTION**

This trial brief is submitted jointly on behalf of intervenors Nashua Photo Inc., District Photo Inc., Mystic Color Lab, and Seattle FilmWorks, Inc. All four companies, being through-the-mail photofinishers, are substantial users of the U.S. mails. Collectively, they are referred to herein as "NDMS." This brief is also supported by another through-the-mail photofinisher, Skrudland Photo, Inc., which never intervened formally but which supports the positions advocated by NDMS in this proceeding. Furthermore, those portions of the brief relating to the proposed Standard Mail A parcel surcharge are also filed on behalf of Merck-Medco Managed Care, L.L.C., an intervenor herein.

## **II. PURPOSE OF THE TRIAL BRIEF**

The Presiding Officer, in his discussion of the requirement that parties file trial briefs in this proceeding "before their witnesses take the stand" (Tr. 1/27), expressed the hope that each party would "set forth in detail its theory of the case" and noted that each party "should include an explanation of the theoretical and public policy considerations which it believes the Commission should give weight to" (*id.*). Pointing out that intervenors' cases "often focus on selected issues," the Presiding Officer stated that the trial briefs "should explain how the proffered evidence should be used in reaching a recommended decision." (*Id.*, p. 29.)

NDMS have sponsored substantial and significant testimony in this proceeding, related to a variety of topics. This testimony, by postal economist Dr. John Haldi, concerns the First-Class Nonstandard Surcharge (NDMS-T-1), Priority Mail (NDMS-T-2), and the proposed Standard Mail A Parcel Surcharge (NDMS-T-3).

Through Dr. Haldi's testimony, NDMS have attempted to share with the Commission important perspectives regarding the significance of certain proposed rate and classification changes in this proceeding, as well as demonstrate why the proposals submitted in the Postal Service's Request for a Recommended Decision in this proceeding should be modified or rejected insofar as those proposals relate to the First-Class nonstandard surcharge, Priority Mail costing and rate design, and a Standard Mail A parcel surcharge. In addition, where NDMS have proposed, as alternatives, modification of the Postal Service's proposal, Dr. Haldi has described the relevant NDMS alternative proposal within the governing statutory/regulatory framework, and has articulated the policy considerations supporting its adoption.

This trial brief provides an overview of the NDMS analysis and alternative proposals, as well as a summary of Dr. Haldi's testimony, and makes reference to relevant views of other parties as expressed in the direct testimony and discovery responses they have filed to date. NDMS have attempted to address the relevant theoretical and policy considerations underlying Dr. Haldi's testimony.

### III. THE POSTAL SERVICE'S REQUEST

The Postal Service's Request for a Recommended Decision initiating this proceeding proposed rate and fee changes affecting all classes of mail, and asserted that without those changes the Postal Service would incur a revenue deficiency of \$2.4 billion in the proposed test year (FY 1998). According to the Postal Service's initial filing, the proposed rates would generate a revenue surplus of approximately \$41.9 million in the test year.<sup>1</sup>

The following paragraphs address those aspects of the Postal Service's Request specifically addressed in the NDMS testimony.

#### A. First-Class Nonstandard Surcharge

The Postal Service proposes to increase the rate for the first ounce of First-Class Mail from 32 to 33 cents, or by **3.1 percent**, and to increase the surcharge applicable to single-piece nonstandard pieces under one ounce by 5 cents, from 11 to 16 cents, or by **45 percent**. This 45 percent increase represents a ten-fold increase over the systemwide average of 4.5 percent in this omnibus rate case.<sup>2</sup>

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<sup>1</sup> The estimated TYAR revenue surplus was later reduced to \$35.6 million USPS-T-9, p. 47 (revised 8/22/97).

<sup>2</sup> See Direct Testimony of Dr. John Haldi, NDMS-T-1, p. 7. As pointed out by Dr. Haldi, the magnitude of this 45 percent increase is exceeded in this proceeding only by the increases of up to 55.6 percent proposed by the Postal Service for Standard A parcels, and the increases proposed by the Postal Service for registered mail. *Id.*, p. 7, fn. 2.

## **B. Priority Mail**

The Postal Service has proposed a number of changes affecting Priority Mail, including higher rates, elimination of the presort discount, and initiation of delivery confirmation service. The Postal Service's average proposed rate increase for Priority Mail is approximately 7.4 percent.

## **C. Proposed Standard Mail A Parcel Surcharge**

In addition to proposing increases in rates for commercial Standard Mail A that average 4.1 percent for "Regular" and 3.2 percent for "Enhanced Carrier Route," the Postal Service's Standard Mail A rate design witness has proposed a 10 cent per-piece surcharge on residual Standard Mail A "parcels" (*i.e.*, mailpieces that are neither letter-shaped nor flat-shaped, *inter alia*).

## **D. The Cumulative Impact on NDMS of the Postal Service's Proposals Would Constitute Severe Rate Shock**

In the past, the Commission has viewed the "fair and equitable" standard of the Act as requiring that it consider the size and impact of proposed changes on discrete segments of the postal market. *See, e.g., Ops. & Rec. Decs.*, Docket No. R87-1, para. 4027, p. 367, Docket No. R77-1, pp. 395-97. A relevant issue becomes whether proposed rate increases create unacceptable "rate shock" on any subclass or rate category. *See, e.g., Ops. & Rec. Decs.*, Docket No. R94-1, paras. 5293, 5300, Docket No. MC95-1, p. V-228. The Postal Service's consideration of such "rate shock" in developing its request appears to have been erratic. With respect to certain products, the Postal Service has attempted to stay within a rate increase cap that was approximately double the average rate increase. *See responses to UPS/USPS-T33-11,*

Tr. 4/1992-93), UPS/USPS-T33-20, (Tr. 4/2014), VP-CW/USPS-T36-5 (Tr. 6/2899). For other products, including the First-Class nonstandard surcharge and the proposed Standard Mail A parcel surcharge, the Postal Service seems oblivious to the effect of rate shock in proposing dramatic rate increases.<sup>3</sup> Further, the Postal Service apparently has not considered the cumulative effect of rate increases on certain mailers such as NDMS.

The proposed 45 percent increase in the First-Class nonstandard surcharge is nearly 4 times the maximum rate increase considered tolerable for any other First-Class rate category, Exhibit USPS-32A. Furthermore, witness Fronk (USPS-T-32) proposed First-Class presort discounts that exceeded identified cost savings solely to avoid rate shock on those First-Class mailers, pp. 27-29. The proposed 55.6 percent increase for Standard Mail A, 3/5 digit, DSCF parcels is 5½ times the maximum rate increase considered tolerable for other Standard Mail A categories. Each of these proposals of the Postal Service, if adopted, viewed alone, would constitute severe rate shock. Taken together, their cumulative effect on large mailers should be considered devastating, and possibly unprecedented. Since NDMS and other intervenors are heavy users of both First-Class nonstandard mail and Standard Mail A parcels, the cumulative rate shock that would result from the Postal Service's nonstandard proposals warrants particular attention.

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<sup>3</sup> The Postal Service has estimated TYAR volume increases for Standard Mail A parcels subject to the surcharge (*see* response to PSA/USPS-T36-8, Tr. 6/2886) and for First-Class one-ounce-and-under nonstandard single piece and presort mail (*see* response to USPS/NDMS-T1-1).

#### **IV. THE INTERVENORS AND THEIR MAIL INTERESTS**

##### **A. Importance of Speedy and Reliable Mail to NDMS**

These intervenors are through-the-mail film processors, which receive exposed film from their customers through the mail and use the Postal Service to return developed film and prints to these customers.

Collectively, through-the-mail film processors account for approximately 6 percent of the domestic film processing market, and compete not only against one another, but also — and especially — against the remaining 94 percent of the market, which is divided among a large number of local, regional and national (*e.g.*, Eastman Kodak, through Qualex, Inc., and Fuji Photo Film, through Fuji Trucolor Inc.) film processing companies that, in general, do not rely upon the mail for film processing. Instead, these non-mail companies rely on the general public taking film to a drop-off location and then returning to the drop-off location to pick up the finished prints. In some localities, competitors do on-site developing and printing, and offer turn-around times as short as one hour.

Speed and reliability of the mails are critical to through-the mail film processors, for turn-around time and service are critical considerations in their direct mail photofinishing business. NDMS operate their respective processing plants up to 24 hours a day, seven days a week, as demand warrants. Their goal is to have finished pictures back into the mail within 24 hours after their customers' film arrives at the plant.



## **B. Mailing Practices of NDMS and Their Customers**

NDMS receive from their customers exposed rolls of 35mm film in light-proof cartridges placed inside envelopes. When mailing exposed rolls of film, some customers drop the cartridge containing exposed film directly into an envelope, while others place the cartridge back in the plastic canister it was purchased in, and then place the canister in an envelope for mailing.

### **1. First-Class Nonstandard Surcharge**

When a single cartridge of 35mm film is returned in an envelope without the canister, it usually weighs less than one ounce and is therefore subject to the First-Class nonstandard surcharge. When the plastic canister is used, the package weighs more than one ounce and is therefore subject to the rate for two-ounce First-Class Mail. Envelopes sent to NDMS that contain a cartridge of film and weigh less than one ounce constituted a significant portion (perhaps as much as one-fourth) of the 24.9 million nonstandard single-piece First-Class parcels that weighed less than one ounce in 1996.

Mystic and Seattle supply all their customers and prospects exclusively with specially-designed business reply envelopes ("BREs") to be used when placing an order. All BREs supplied by Mystic and Seattle are returned directly to each firm at their respective plants. On all incoming BRE mail, Mystic and Seattle thus pay all applicable First-Class postage, including the First-Class nonstandard surcharge.

Nashua and District receive both BREs and reply envelopes with postage prepaid by the customer. When customers use BREs, Nashua and District pay all applicable First-Class postage, including the First-Class nonstandard surcharge. For single rolls of film without

canisters which are under one ounce, when reply envelopes are prepaid by customers, they are supposed to include the surcharge. Many customers overpay, by putting two 32-cent stamps or a 32-cent and 23-cent stamp on the envelope. Other customers underpay, by putting only one 32-cent stamp on the envelope. In the former situation, the Postal Service retains the overpayment; in the latter situation, the Postal Service collects the nonstandard surcharge from Nashua or District as postage due.

## **2. Priority Mail**

NDMS either distribute envelopes addressed for return directly to each firm at its respective plant, or to be sent to post office boxes strategically located around the country. Certain of these companies use the Priority Mail Reship Service to expedite the transportation of customer orders from these post office boxes to their plants.

Packages containing customers' exposed film are received at a plant, opened, processed and put into envelopes to be sent back to customers. Outgoing orders are sorted and sacked. Most packages returning the finished photo product to customers weigh less than one pound. All four companies use an expedited dropship service to send these packages to destinating SCFs, at which point the individual customer envelopes are entered as Standard Mail A, for final delivery. The vast majority of dropship to SCFs is via Priority Mail dropship.

Each day, NDMS collectively dispatch several truckloads of sacks containing these packages of finished photo products to the nearest major airports, and to certain other nearby postal facilities. Nashua and District believe they are among the pioneers in using Priority Mail dropship. Their Priority Mail sacks typically weigh anywhere from 15 pounds up the

maximum of 70 pounds. When a package of prints weighs more than one pound, certain companies send such packages direct, often via Priority Mail.

### **3. Proposed Standard Mail A Parcel Surcharge**

Exposed rolls of film are received from customers accompanied by orders to develop the film and make prints. Most rolls of film have 24 or 36 exposures, and customers may order a single or double set of prints. The flat strips of developed film, cut into suitable lengths and enclosed in protective jackets, are placed inside paper, Tyvek®, or plastic envelopes, together with any prints or enlargements which are stacked inside. The resulting envelopes are then dropshipped via expedited service to the appropriate SCF, where they are entered as Standard Mail A. Envelopes containing sets of prints are either flat- or parcel-shaped, a packaging decision that is currently not driven by postage costs. Parcel-shaped mailpieces are almost always mailpieces that would be classified as flats if they did not exceed the maximum flat thickness of 3/4". Standard Mail A envelopes mailed by NDMS that are parcel-shaped currently are estimated to constitute about 30-40 percent of NDMS's Standard Mail A pieces.<sup>4</sup>

As already mentioned above, the Postal Service's Standard Mail A rate design witness has proposed a surcharge of 10 cents per piece for all parcels. The surcharge would apply to

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<sup>4</sup> Dr. Haldi's testimony regarding the proposed parcel surcharge was also sponsored by Merck-Medco Managed Care, L.L.C., a subsidiary of Merck & Co., Inc., and the leading pharmacy benefits manager in the United States. Merck-Medco manages pharmaceutical care for millions of Americans covered by employer-funded health plans, major insurance carriers, labor unions, public sector programs, and managed care plans. It uses Standard Mail A to distribute pharmaceuticals to its customers. Many of these mailpieces would be classified as flats except for exceeding the maximum flat thickness of 3/4".

all pieces which exceed any of the following dimensions: height of 12", width of 15", or thickness of 3/4".<sup>5</sup> The surcharge would apply to all Standard Mail A parcels, so defined, without exception, and without any consideration of whether such parcels were machinable. It would also apply to any other Standard Mail A (*e.g.*, flats) "prepared as parcels".<sup>6</sup> Obviously, unless they changed their mail practices and repackaged these "parcels" as flats, each of the photofinishers, along with other Postal Service customers transmitting "parcels" through the mails, would suffer an extremely adverse impact from this proposed surcharge.

**C. Relevant Direct Testimony of NDMS and Other Intervenors**

**1. First-Class Nonstandard Surcharge**

NDMS opposes the Postal Service's proposed increase to the surcharge on First-Class nonstandard pieces — as well as any continuation of the surcharge — for the reasons articulated in the testimony of Dr. John Haldi (NDMS-T-1). NDMS not only believe that the proposed surcharge increase lacks justification, but also that the current surcharge on nonstandard First-Class mailpieces should be abolished.

No other parties filed testimony directly supporting or opposing the proposed surcharge on First-Class nonstandard pieces.<sup>7</sup>

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<sup>5</sup> These are the maximum dimensions of a flat, as defined in DMM §C050.3.1.

<sup>6</sup> USPS Request, Attachment A, pp. 25-26.

<sup>7</sup> The testimony of witness Jellison on behalf of Parcel Shippers Association ((PSA-T-1) mentions the surcharge as an illustration, but takes no position on the First-Class nonstandard surcharge. *See* PSA-T-1, p. 24.

## **2. Priority Mail**

NDMS propose modifications to the Postal Service's rate proposal to promote better Priority Mail rate design. Dr. Haldi expressed concern that the proposed Priority Mail cost coverage is too high, but he did not propose a lower alternative cost coverage (NDMS-T-2).

The only other intervenor to file testimony directly pertaining to Priority Mail at this stage of the proceeding is the Postal Service's competitor, United Parcel Service ("UPS"). The testimony of UPS attempts to persuade the Commission to raise all Priority Mail rates, and is adverse to the interests of NDMS, the Postal Service, and, it is submitted, Priority Mail users nationwide. UPS has suggested that \$300 million in additional mail processing costs be attributed to Priority Mail, that an additional fee for Priority Mail delivery confirmation be charged, and that a surcharge of 10 cents should be imposed on all Priority Mail parcels.

## **3. Proposed Standard Mail A Parcel Surcharge**

No testimony was submitted by intervenors or the OCA in support of the Postal Service's proposed Standard Mail A Residual Shape surcharge.

Several parties, as well as NDMS, filed testimony opposing the proposed parcel surcharge. Dr. John Haldi's testimony opposing the proposed surcharge (NDMS-T-3) exposes not only the specific shortcomings in the revenue, volume, and cost data relied upon by the Postal Service, but also the Postal Service's failure to study and recognize certain consequences adverse to the Postal Service that are likely to result if the proposed surcharge were recommended and adopted. As Dr. Haldi demonstrates, the Postal Service's proposal lacks merit in four critical respects. These shortcomings should persuade the Commission to

recognize the dearth of evidence justifying the proposal and not recommend a parcel surcharge in this docket.

The Recording Industry Association of America and the Advertising Mail Marketing Association sponsored testimony by Gary Andrew (RIAA, et al.-T-1), which criticizes the analysis of witness Crum (USPS-T-28). Using witness Crum's calculated flat/parcel cost differential of 33.4 cents per piece, witness Andrew demonstrates that the differential should be reduced to 27.79 cents per piece (taking account of recalculated mail processing costs and revised estimates of parcel density), which, less the estimated flat/parcel revenue differential of 24.60 cents per piece, results in a net flat/parcel revenue differential of 3.2 cents per piece.

Parcel Shippers Association ("PSA") sponsored the testimony of its Executive Vice President, Jim Jellison, in opposition to the Standard Mail A residual shape surcharge (PSA-T-1). Witness Jellison, echoing PSA's criticism of the proposed parcel surcharge in Docket No. MC95-1, noted that:

- the Commission's finding in that docket that Standard Mail A parcels fail to cover their costs was unsupported by record evidence; and
- Standard Mail A flat and letter mailers, who are allegedly injured by this cross-subsidy, have never sought such a surcharge (PSA-T-1, p. 20).

Witness Jellison's criticism of the surcharge proposed in this docket by the Postal Service included the following points:

- **Insufficient net revenue evidence.** The Postal Service has not demonstrated that witness Crum's flat/parcel cost differential, presented as evidence in support of the surcharge USPS-T-28), is caused by shape. Witness Jellison also noted the "fragility of the cost data" relied upon by witness Crum. For example, the Standard Mail A ECR flat/parcel cost differential jumped from **22.7 cents per piece** in FY 1995 (the Base Year for Docket No. MC97-2) to **39.1 cents per piece** in FY 1996 (the Base Year for Docket No. R97-1),

**without explanation (p. 22).** Witness Jellison observed that the Postal Service has never stated that Standard Mail A parcels fail to cover their costs. Instead, the proposed surcharge is predicated on the fact that Standard Mail A parcels cost more to process than Standard Mail A flats. Witness Jellison estimates that in the Base Year, the average Standard Mail A Regular parcel produced **22.15 cents per piece** more revenue than the average Standard Mail A Regular flat, using data from USPS-T-28, Exhibit K. Witness Jellison estimated a 33.1 cent per-piece flat/parcel cost differential, again using data from USPS-T-28, Exhibit K. He then followed witness Crum's approach of reducing this amount by 7.3 cents per piece to reflect the deeper entry and finer presortation of flats, obtaining a flat/parcel cost differential of 25.8 cents per piece. This leaves a net Standard Mail A Regular flat/parcel differential of **2.65 cents per piece** (pp. 25-28).

- Improper cost averaging combining subclasses, impact of rate shock.** Witness Jellison stated that Standard Mail A parcels were penalized by the Postal Service's approach of estimating the combined cost per piece and revenue per piece for all four categories of Standard Mail A parcels (*i.e.*, Standard Mail A Regular, Standard Mail A ECR, Nonprofit Regular and Nonprofit ECR), and that mailpieces from separate rate categories and subclasses, with separate and distinct costs and revenue yields, should not be lumped together and treated as identical. He compared the Postal Service's evidence supporting the residual shape surcharge to an effort to impose a surcharge on Standard Mail A Regular parcels because of the net flat/parcel differential of First-Class sealed parcels (pp. 28-29). He objected to the Postal Service's proposed imposition of rate increases over 50 percent in an effort to reduce Standard Mail A flat rates by only 1/3 cent per piece (p. 30).

## **V. ARGUMENT**

### **A. First-Class Nonstandard Surcharge**

Dr. Haldi urges abolition of the current First-Class Nonstandard Surcharge (of 11 cents). Volumes and revenues of mailpieces subject to the surcharge are relatively minimal, making this rate category a poor target for rate de-averaging. In addition, the same mailers who are asked to pay the surcharge on lightweight pieces are also required to pay the excessive 23-cent increment on successive ounces. Moreover, many of the circumstances that gave rise to its creation no longer exist. Finally, the Postal Service has failed to demonstrate that such a surcharge is appropriate and justifiable.

If the Commission ultimately is not prepared to recommend abolition of the surcharge, NDMS would submit alternatively that the Postal Service's proposed increase in the surcharge (of 5 cents, from 11 to 16 cents per piece) be rejected and that the existing surcharge be reduced. Based on currently available cost, volume, and revenue figures, and pending further study, the existing surcharge should be reduced to no more than 4 to 5 cents per piece.

#### **1. The Record Evidence Provides No Valid Reason for Continuing the Surcharge**

The initial decision to de-average rates and adopt a surcharge for nonstandard pieces is now over 20 years old. Mailpieces subject to the surcharge, especially letters and flats, are handled very differently in 1997 than in the early 1970s. By seeking to increase the surcharge by 45 percent, the Postal Service has put the entire surcharge issue — and not merely the amount of the proposed increase — on the table for examination. In view of the underlying facts, the issue of the surcharge should be revisited in its entirety (NDMS-T-1, p. 3).



**a. The Postal Service Has Failed to Demonstrate That the Reasons for Imposing a Surcharge Continue to Exist**

The nonstandard surcharge represented an effort to de-average rates within single piece First-Class Mail, assigning to nonstandard pieces the roughly estimated additional costs of handling nonstandard mail. However, the Postal Service has not demonstrated any continuing need for such a charge. As Dr. Haldi has pointed out, new sorting machines have been deployed without any comment or analysis by the Postal Service as to whether they are capable of processing “nonstandard pieces” as originally defined in Docket No. MC73-1, and equipment already installed and in wide use by the Postal Service for processing letters appears able to efficiently process nonstandard pieces by the Postal Service’s own admission. NDMS-T-1, pp. 10-11. Moreover, a small experiment conducted by Dr. Haldi exposed the inaccuracy of Postal Service testimony in this docket that all nonstandard pieces are sorted manually, by demonstrating that certain Postal Service equipment is capable of processing — and is used to process — certain nonstandard letters. NDMS-T-1, pp. 11-12. The original basis for the nonstandard surcharge — higher mail processing costs — may no longer exist for nearly all the volume subject to the surcharge.

**b. The Postal Service’s Cost Data Do Not Support a Surcharge**

Although the techniques and equipment for mail processing have progressed significantly over the past 20 years, the Postal Service has offered no study or analysis of any kind supporting continued applicability of the original premise for the surcharge. Instead, it has simply offered data purporting to reflect the costs incurred by certain types of First-Class Mail mailpieces. As Dr. Haldi has demonstrated (NDMS-T-1, pp. 23-30), the Postal

Service's cost analysis is flawed and inadequate. The Postal Service admits that it does not know the cost it incurs to process an under-one-ounce letter, flat or parcel, and that it bases the surcharge on cost proxies (which Dr. Haldi has been demonstrated to be unreliable proxies for the intended purposes). The Postal Service has not presented credible evidence that would support *any* surcharge for nonstandard First-Class pieces one ounce and under, to say nothing of its proposed 45 percent increase to the existing surcharge.

**c. The First-Class Nonstandard Surcharge Is Bad Postal Policy**

After pointing out a number of reasons why the First-Class nonstandard surcharge is in need of re-evaluation, Dr. Haldi states:

[N]o consistently-applied principles — based either on cost or volume — have emerged over the past 20 years to support continued de-averaging of single piece First-Class rates, either by discounts or surcharges. [NDMS-T-1, p. 16.]

He then goes on to demonstrate that the volume of nonstandard First-Class single piece mail is so small, and the revenues from the surcharge are so small, that such mail is not deserving of a separate rate category. *See* NDMS-T-1, pp. 19-23. Indeed, in this very proceeding, the Postal Service has proposed elimination of a comparable (in volume) rate category — heavy-weight presort First-Class Mail — on the grounds that the low volume of such mail, as well as considerations of rate simplification, militate in favor of eliminating the rate category. The same rationale calls for elimination of the First-Class nonstandard surcharge. As Dr. Haldi states:

The Commission should give serious consideration to the advisability of maintaining any rate category that constitutes well under 1 percent of volume — and one-tenth of 1 percent of revenue — of First-Class Mail. If the Commission were to affirm

the surcharge, this precedent could be used to justify almost limitless "balkanization" of First-Class Mail. Moreover, it could open the door to doing so in a seemingly arbitrary fashion.... [NDMS-T-1, p. 42.]

There is a major policy issue as to the extent to which rates for First-Class Mail, the one rate category used most by the general public, should be "balkanized" and subject to confusing surcharges or other pricing nuances.

Dr. Haldi identifies the underlying policy issue:

Cost-driven de-averaging can be applied to distinguish any subsegment of mail whose average processing cost differs significantly from the average processing cost of the segment as a whole, supporting the creation of additional rate categories. Of course, the quest for more cost-based rates can justify any and all de-averaging, however wise or foolish it may be.

The key issue is: under what conditions should rate categories be created and such de-averaging built into the rate structure? [NDMS-T-1, p. 36.]

The Commission should evaluate the extent to which the Postal Service's *ad hoc* imposition of surcharges is consistent with 39 U.S.C. Section 3622(b)(1), "the establishment of a fair and equitable rate schedule." The Commission should also consider how such surcharges affect 39 U.S.C. Section 3622(b)(7), "simplicity of structure for the entire schedule and simple, identifiable relationships between the rate or fees charged the various classes of mail for postal services."

**d. Flats and Parcels are Highly Profitable Products Because of Excessive Extra-Ounce Charges**

The revenues from First-Class flats and parcels greatly exceed their respective costs, because the fee charged for extra ounces (proposed to remain at 23 cents per ounce, which is equivalent to \$3.68 per pound) appears to be much greater than the cost of handling extra

weight (NDMS-T-1, page 33). These fees are often paid by the same mailers who must pay the extra fee for light-weight nonstandard pieces. Since the extra ounce fee is excessive, there is a strong argument for allowing pieces under one ounce to be rate-averaged with similar pieces that weigh more than one ounce.

**2. In the Alternative, the Amount of the Current First-Class Nonstandard Surcharge Should Be Reduced**

The Postal Service's Request, insofar as it seeks to increase the current First-Class nonstandard surcharge from 11 cents to 16 cents, lacks credible support in the record, relying upon cost data which have no specific application to the First-Class nonstandard pieces sought to be surcharged. Nevertheless, if the Commission does not choose to eliminate the surcharge at this time, NDMS would urge the Commission, in accordance with Dr. Haldi's recommendation, to reject any increase in the current surcharge and to decrease the current surcharge to a maximum of 4 or 5 cents. *See* NDMS-T-1, pp. 45-47.

Even such a reduced surcharge should only be imposed if the Postal Service has demonstrated that nonstandard letters and flats are actually processed manually. NDMS-T-1, p. 46, lines 10-16. If the Commission were able to derive such evidence from the record, a reduced surcharge reflecting the difference between the verifiable average costs of First-Class letters and manually processed letters (8.8 cents), together with a reasonable (50 percent) passthrough, would be the most that could be considered consistent and fair under the circumstances of this case. NDMS-T-1, pp. 46-47.

## **B. Priority Mail**

Priority Mail has become a highly profitable and successful product for the Postal Service. FY 1996 revenues and operating profit (*i.e.*, contribution to institutional costs) of Priority Mail were, respectively, \$3,321.5 million and \$1,681.3 million. The operating profit from Priority Mail was 4.5 times greater than the operating profit of **all** Periodicals and **all** Standard B mail, **combined**. Viewed differently, the operating profit from Priority Mail exceeded the combined operating profit of all domestic and international postal classes of mail and special services combined, excepting First-Class Mail and Standard Mail A.<sup>8</sup> The testimony submitted by Dr. Haldis seeks Priority Mail as a Postal Service product, by increasing its attractiveness to Priority Mail users.

Specifically, Dr. Haldis proposed:

- (i) a classification change that would permit pieces weighing up to 13 ounces to be entered as First-Class Mail (a change which has an indirect but important effect on Priority Mail);
- (ii) an alternative procedure to project Test Year After Rates volumes and revenues by applying the estimated own-price elasticity to individual rate cells; and
- (iii) alternative rates for Priority Mail. [NDMS-T-2, p. 3.]

### **1. Proposed Classification Change: Reducing the Gap**

The NDMS-proposed classification change would increase the maximum weight of First-Class Mail from 11 ounces to 13 ounces, reduce the gap between the rate for the

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<sup>8</sup> The same is true for FY 1997. Priority Mail was 0.6 percent of Postal Service volume, but provided 7.7 percent of Postal Service institutional contribution — more than all other postal products (except First-Class Mail and Standard Mail A) combined. 1997 Annual Report of U.S. Postal Service, p. 22.

maximum weight of First-Class Mail (\$2.63 under the Postal Service's proposal) and the minimum rate for Priority Mail (\$3.20 under the Postal Service's proposal), and give mailers additional options regarding how they wish to send pieces that weigh 12 and 13 ounces. This proposal is supported by considerations of rational relationships between rate classes, fairness, and Commission precedent. As Dr. Haldi explained:

Clearly, the proposed gap of \$0.57 between the maximum First-Class rate and the minimum Priority Mail rate is not as small as possible. Moreover, no good reason has been proffered as to why a gap this large should be considered acceptable. Such a large gap is not readily understandable by Postal Service customers. Moreover, there is no operational reason why 12- or 13-ounce pieces cannot be handled within the First-Class mailstream. The breakpoint has been 13 ounces in the past, as discussed *supra*. Priority Mail is a subclass of First-Class Mail. It is important that there be a rational relationship between the maximum First-Class Mail rate and the minimum Priority Mail rate.

At the same time, it is equally important that the current 11-ounce maximum weight for First-Class Mail not be maintained if it results in an artificially low two-pound-and-under Priority Mail rate. This rate applies to 80 percent of all Priority Mail volume. An artificially low two-pound-and-under rate can have a disastrous effect on rates paid by mailers of zoned Priority Mail due to the relatively small volume of zoned Priority Mail.

In Docket No. R94-1, the Commission held the two-pound-and-under Priority Mail rate down to \$3.00 despite an indicated rate of approximately \$3.10. The effect of setting less-than-indicated rates for unzoned 5-pound-and-under Priority Mail was to force every zoned parcel over 5 pounds to pay an extra \$1.30 cents. The result of high zoned rates was a sharply reduced rate of growth in zoned Priority Mail. [NDMS-T-2, pp. 14-15, as revised 2/9/98.]

As Dr. Haldi went on to explain, ample precedent exists for such a recommendation by the Commission, which on several prior occasions has changed the maximum weight of First-Class

Mail for reasons consistent with good ratemaking policy (*e.g.*, preventing rate anomalies or reducing unusually large gaps between First-Class Mail and Priority Mail). NDMS-T-2, p. 15. In this proceeding, such a measure would have a *de minimis* revenue effect, with the net reduction in Postal Service revenues projected at approximately \$22.5 million. NDMS-T-2, p. 16.

## **2. Alternative Procedure for Priority Mail Volume and Revenue Projections**

Dr. Haldi points out that the econometric model used by the Postal Service to forecast growth in demand for Priority Mail disregards the effect of non-uniform increases in rates, and has resulted in anomalous predictions of after-rates volume and revenue. (NDMS-T-3, pp. 17-22.) Accordingly, Dr. Haldi has proposed an alternative procedure, whereby test-year-before-rates ("TYBR") volume is distributed to each rate cell (in proportion to base-year volume in each cell) and, using the Postal Service's estimate of own-price elasticity for Priority Mail, test-year-after-rates ("TYAR") volume is projected by applying both the own-price elasticity and the proposed percentage rate change to the TYBR volume in each rate cell. This produces results — lower volumes resulting from higher rates, and vice versa — that are intuitive, logical, and in accord with sound economic principles. *See* NDMS-T-3, pp. 22-26.

## **3. Developing Cost-Based and Competitive Rates**

It is an undisputed fact that Priority Mail suffers a number of competitive disadvantages in the marketplace. Dr. Haldi testified that, "in order to compete successfully for the entire spectrum of packages weighing up to 70 pounds, Priority Mail needs to have a pricing structure which sufficiently compensates at every weight level and in each zone for its other

disadvantages.” Accordingly, he has proposed rates for Priority Mail which would make three modifications in the principles/procedures used by the Postal Service to design rates for Priority Mail.

- No mark-up would be imposed on the distance-related component of transportation costs;
- Within the unzoned, flat-rate weight range (up to 5 pounds), each pound increment would reflect the same additional fee; and
- Presort discounts would be eliminated. (*See* NDMS-T-3, p. 27.)

According to Dr. Haldi, such changes “will provide a rate structure to Priority Mail that not only reflects costs more appropriately, but is also more competitive.” *Id.* His proposed rates have been designed with a slightly higher level of coverage than that proposed by the Postal Service. Priority Mail volume would also decrease slightly (from that projected by the Postal Service) under the NDMS proposal, although revenues would slightly increase. (NDMS-T-3, pp. 48-49.) In his proposal, Dr. Haldi has addressed at length the statutory criteria set forth in 39 U.S.C. section 3622(b) (NDMS-T-3, pp. 49-52), and has demonstrated that not only are his proposed rates more cost-based than those requested by the Postal Service, but that they would also restore balance in the Priority Mail rate schedule and would make “good business sense” (NDMS-T-3, pp. 52-56).

### **C. Proposed Standard Mail A Parcel Surcharge**

The Postal Service has proposed a 10-cent per-piece Standard Mail A residual shape surcharge (the “parcel surcharge”). As discussed *supra*, no intervenor has submitted testimony



supporting the proposal. NDMS,<sup>9</sup> along with other intervenors, strongly oppose and urge the Commission to reject, the proposed parcel surcharge. On behalf of NDMS, Dr. John Haldi studied the Postal Service's proposal, subjecting it to critical evaluation. Such study led to Dr. Haldi's testimony in this proceeding (NDMS-T-3), wherein Dr. Haldi has summarized his conclusions regarding the parcel surcharge proposal as follows:

I show that imposition of the surcharge would likely lead to extensive repackaging of mailpieces, an expenditure by mailers that could perversely **reduce Postal Service revenues, while increasing handling costs**, thus producing the opposite of the outcome sought by the proposal. I further demonstrate that the cost basis underlying the proposed surcharge is gravely defective, and that de-averaging of transportation costs used to justify the surcharge is inconsistent and inequitable vis-a-vis destination entry discounts. As proposed, the surcharge should be rejected. [NDMS-T-3, p. 3.]

Dr. Haldi not only demonstrates the analytical, definitional, and conceptional deficiencies in the Postal Service's proposal, but also points out the serious, unintended consequences that would likely result if such a surcharge were adopted.

**1. Obvious Deficiencies Exist in the Postal Service's Proposal**

**a. The Postal Service's Proposal Does Not Meet the Standards Set by the Commission in Docket No. MC95-1 for a Standard Mail A Parcel Proposal**

Postal Service witness Moeller (USPS-T-36) stated that the Postal Service's proposal for a Standard Mail A residual shape surcharge arose out of the testimony of two UPS witnesses (Blaydon and Luciani) in Docket No. MC95-1. USPS-T-36, p. 11. According to

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<sup>9</sup> As stated above, Merck-Medco Managed Care, L.L.C., supports the position of NDMS with respect to the proposed Standard Mail A parcel surcharge.

witness Moeller, the Postal Service's proposal "responds to the Commission's and the dissenting Commissioners' concerns by increasing revenue from these pieces, thereby helping to alleviate the 'below cost rate problem.'" *Id.*, p. 12.

In Docket No. MC95-1, the Commission stated that UPS had "identified the fact that the average revenue for the proposed Standard Mail regular parcels is less than the average cost for those pieces." *Op. & Rec. Dec.*, Docket No. MC95-1, para. 5569.<sup>10</sup> But, the Commission found that the evidence was insufficient to support any proposed Standard Mail A parcel rates in that docket. The Commission urged "the Postal Service to develop expeditiously a comprehensive parcels proposal with supporting information." *Id.*<sup>11</sup> The Postal Service had already undertaken "analyses of parcel costs and market characteristics," *Id.*, para. 5566.

In this docket, the Postal Service presented an analysis of "Standard Mail (A) Unit Costs by Shape" (LR-H-108, which, with amendments, later became Exhibit K of USPS-T-28). Exhibit K does purport to "estimate" the unit attributable costs for Standard Mail (A) flats and parcels. *Id.*, p. 1. However, it offers **no analysis** of market characteristics. Curiously,

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<sup>10</sup> The Commission did not cite any specific "average revenue" or "average cost" data for Standard Mail A parcels in its *Opinion & Recommended Decision*, Docket No. MC95-1. Intervenors noted that the UPS testimony in Docket No. MC95-1 relied on nonrecord evidence, a practice which has been extensively litigated in this docket. *Id.*, para 5535; *see also* Tr. 11/4047-4048, Docket No. MC95-1.

<sup>11</sup> The Postal Service has characterized its proposed surcharge as a "comprehensive parcels proposal with supporting information" as had been requested by the Commission in Docket No. MC95-1. (USPS Trial Brief, p. 38.)

the Postal Service estimates the surcharge will result in a 22 percent increase in volume over the Base Year. *See* response of witness Moeller to PSA/USPS-T36-8 (Tr. 6/2886).

The Commission, in Docket No. MC95-1, had also been led to believe that the Postal Service was "about to provide the data necessary to develop a rate design which best resolves the problems identified on this record by PSA and RIAA." *Op. & Rec. Dec.*, Docket No. MC95-1, paras. 5555, 5557-58, 5566-67. The Commission had recognized several such problems:

- PSA discussed the lack of record evidence that shape is a dominant cost influence in mail handling, and that parcels are systematically more costly to handle than flats. *Op. & Rec. Dec.*, Docket No. MC95-1, para. 5540; This lack of record evidence still exists.<sup>12</sup>
- PSA presented samples of the shape of many third-class parcels, demonstrating several have shapes that are far more like the shapes of flats than the shapes of

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<sup>12</sup> When asked whether "the Postal Service has performed studies which show that shape is the factor that differentiates the costs of flats from those of nonflats," witness Moeller did not identify any such study. He only observed that "[w]itness Crum's testimony (USPS-T-28) describes a study which measures the cost differences between flats and other nonletters." *See* response to DMA/USPS-T36-9, Tr. 6/2747. Measuring cost differences is not the same thing as documenting what drives or causes a cost difference.

Witness Moeller stated that, "I think we have a study that shows that shape is a big cost determinant." Tr. 7/3159, ll. 1-2. But the study is merely an estimate of the unit attributable costs for flats and parcels in Standard Mail A. USPS-T-28, Exhibit K, p. 1. In fact, the "study" contains no discussion of what caused these costs to vary by shape.

Furthermore, there is no record evidence that parcels are systematically more costly to handle than flats of the same weight. Postal Service witness Crum's analysis (USPS-T-28) simply assumes that weight has no significant effect on Standard Mail A costs. Witness Crum expressly stated: "I have no data to show that weight per se has a significant impact on Standard Mail (A) parcel costs." *See* response to NDMS/USPS-T28-26, Tr. 5/2242.

other parcels. *Id.*, para. 5541. The Postal Service has not dealt with such evidence militating against a parcel surcharge.<sup>13</sup>

- RIAA addressed the lack of data supporting a separate Standard Mail A parcel rate, including no definition parameters of affected mailpieces, no identification of the different procedures (and resultant costs) for machinable and nonmachinable parcels, and no analysis of potential volume shifts among classes and subclasses of mail. *Id.*, para. 5544. The Postal Service's proposal lacks in all of those regards.<sup>14</sup>
- RIAA observed that "the calculation of the 'average cost' of a 'parcel' proves nothing about the range of costs that made up that average." *Id.*, para. 5546. The Postal Service's proposal does not adequately address that concern.<sup>15</sup>

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<sup>13</sup> Witness Crum acknowledged during oral cross-examination that IOCS tally takers (whose records formed the basis for his Exhibit K), may have confused flats and parcels. Tr. 5/2384 ll. 2-7. The Postal Service's proposed surcharge does not distinguish between parcels that approach or meet the definition of a flat-shaped mailpiece, and parcels which have an irregular shape. Thus, the Postal Service proposal does not address this concern of PSA.

<sup>14</sup> Postal Service witness Moeller testified that the surcharge applied to "every piece of Standard Mail (A) that is neither letter- nor flat-shaped." USPS-T-36, p. 12. Yet witnesses Crum and Moeller observed that, under the Postal Service's proposals, some flat-shaped (but "parcel-prepared") mailpieces would also be subject to the surcharge. RIAA's criticism in Docket No. MC95-1, that the proposed Standard Mail A parcel rates lack simple, clear definition parameters, remains valid.

<sup>15</sup> Postal Service witness Moeller observed that "there is some degree of rate averaging involved with most rate categories." See response to DMA/USPS-T4-23 (redirected to witness Moeller), Tr. 6/2751. Citing rate averaging in defense of his proposal not to recognize the letter-flat differential in Basic ECR, he stated that such rate averaging was not a cross-subsidy. See Tr. 7/3146, l. 24 to 7/3147, l. 14. However, although he also does not identify any cross-subsidy between Standard Mail A residual shape mail and Standard Mail A letters and flats in his testimony, witness Moeller does not extend the same rate averaging principle to Standard Mail A nonletter rates.

By contrast, in Docket No. R90-1, when the Commission recommended **shape-based** rate categories for third-class mail for the first time, the Commission found that "shape, as long suspected, does have an effect on costs, but...**this effect is determined in part by presort level and delivery patterns.**" *Op. & Rec. Dec.*, Docket No. R90-1, p. V-226, emphasis added. In addition, the Postal Service testified in Docket R90-1 "that the costs show not only that letters are less costly than flats, but that **the differential declines with finer presortation.**" *Id.*, emphasis added.

**b. If Adopted, the Proposed Surcharge Would Constitute a Problematic Precedent**

According to Postal Service witness Moeller, "[t]he point of the surcharge isn't to assure cost coverage or that the revenues exceed the costs; it is to recognize cost differences between these two groupings of mail." (Tr. 6/2948, ll. 19-22.)

Although the Commission's interest in a parcel surcharge, as expressed in its Opinion and Recommended Decision in Docket No. MC95-1, appears related to a possible below-cost rate problem, the Postal Service does not assert that such a problem exists. For example, Postal Service witness Moeller did not testify that the Postal Service's proposal was based on a failure of Standard Mail A parcels to cover their costs. Although stating that his proposed Standard Mail A residual shape surcharge "responds to the Commission's and the dissenting Commissioners' concerns by increasing revenue from these pieces, thereby solving any "below cost rate problem," USPS-T-36, p. 12, witness Moeller later stated that "the 'difference between revenues and costs'" incurred by parcels "is not relevant to the rate design" underlying the residual shape surcharge (Tr. 6/2816-17, NDMS/USPS-T36-1-2). Witness Moeller suggested that any comparison between the average revenue and average cost incurred by the average Standard Mail A Parcel is not relevant to the proposed surcharge, and that the Postal

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In this docket, however, the Postal Service conducted less analysis than it performed in Docket No. R90-1, neglecting to identify and analyze the effect of presort level and depth of dropshipment on the respective shape-based parcel and flat costs incurred. Thus, the impact of presort level and depth of dropshipment on parcel and flat costs incurred remains a subject of speculation.

Service's proposal was not based upon the difference between parcel revenue and parcel costs, but rather the allegedly higher (than flats) mail processing costs of parcels. (Tr. 6/2947, ll. 22-24; Tr. 6/2848, ll. 7-11 and 19-22.)

In other words, the Postal Service does not base its parcel surcharge proposal upon the existence of a "below cost-rate problem." Moreover, despite the fact that it bases its proposed parcel surcharge on the alleged difference<sup>16</sup> in cost between parcels and flats, the Postal Service has failed to present a single cost model showing how any parcel is handled. Any study demonstrating how costs vary in handling different types and shapes of parcels is completely lacking. *See* NDMS-T-3, pp. 20-25. As Dr. Haldi demonstrates, the Postal Service — which has relied exclusively on the difference in certain "costs" to support its proposed surcharge — has failed to gather the appropriate data for its request, and "the conceptual foundation of the cost data used for rate making is gravely deficient." NDMS-T-3, p. 29.

The testimony of witness Crum purports to furnish the underlying factual (cost) basis for the Postal Service's proposal. However, Dr. Haldi points out in his testimony (NDMS-T-3, pp. 31-39) that witness Crum's cost data:

- rely on mail processing cost estimates which exhibit wide, inexplicable differences;
- fail to study (and underestimates as a result) shape-based presort costs avoided by parcels;

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<sup>16</sup> Although the Postal Service purports to have identified different handling costs for parcels ("residual shapes") and flats, it has admitted that flats and parcels can have the same dimensions, and that some flat-shaped mailpieces would also be subject to the surcharge. *See* NDMS-T-3, p. 27; response of witness Moeller to DMA/USPS-T36-3 (Tr. 6/2740).

- incorporate delivery cost estimates which exhibit even wider and more inexplicable differences than the mail processing costs;
- fail to identify any cause which could explain the mail processing and delivery cost differences;
- rely on estimated transportation costs which reflect uncertainties and inconsistencies;
- utilize a density estimate which is dramatically and inexplicably different from prior density estimates for Standard Mail A parcels; and
- derive destination entry discounts from averaged, not shape-based, transportation costs.

Clearly, the Postal Service needs to obtain better data, and a surcharge based upon the current record would be inequitable. Dr. Haldi has suggested that the Commission should defer recommending any parcel surcharge pending such further study, and that, if some action is necessary, that the Commission should consider recommending a shell classification and request the Postal Service to submit a new proposal which corrects the most serious shortcomings in the current proposal. Should the Commission nevertheless decide to recommend a surcharge at this time, Dr. Haldi's testimony shows that the surcharge should not exceed 2 or 3 cents.

## 2. The Postal Service's Proposal Would Create Unintended Incentives Defeating the Object of the Surcharge

As Dr. Haldi has pointed out in his testimony (NDMS-T-3, pp. 13-19), the Postal Service's proposed parcel surcharge would not have the revenue-enhancing effect envisioned by the Postal Service in advancing this poorly-conceived measure. Dr. Haldi testified:

The Standard Mail A parcel surcharge, as proposed by the Postal Service in this docket, is extraordinarily myopic. It contains no

incentives for reducing Postal Service costs, either via increasing the machinability of parcels or by other increased worksharing. As indicated above, mailers' only incentive would be to repackage, which could lead to unintended and counterproductive effects on the Postal Service's bottom line. Should such mischief result, the net incentive effect of the surcharge could turn out to be highly perverse, and certainly not revenue-enhancing. The surcharge is not even intended, as I show in the next section, to deal with the balance between revenues and costs; it is narrowly focused on cost differences whose conceptual underpinnings are seriously defective. [NDMS-T-3, p. 19.]

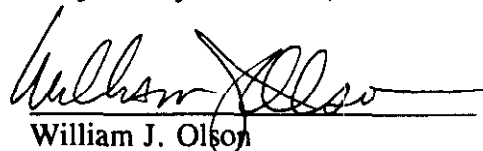
The unintended consequences referred to by Dr. Haldi are based upon logic, knowledge of mailers' practices, and the obvious defects in the Postal Service's proposal. They would defeat the very purpose of the parcel surcharge, and can be avoided only if the surcharge proposal is laid to rest.



**VI. CONCLUSION**

NDMS submit that their testimony filed herein support their rate and classification proposals, and that the Postal Service's request with respect to the First-Class nonstandard surcharge, Priority Mail and the proposed Standard Mail A parcel surcharge should be modified or rejected as set forth in Dr. Haldi's testimony.

Respectfully submitted,



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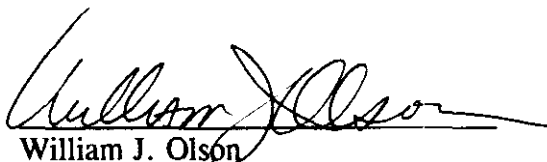
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**CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.



William J. Olson

February 10, 1998